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SUBJECT: AMBASSADOR CALLS ON ENERGY SECRETARY

SENSITIVE BUT UNCLASSIFIED - NOT FOR INTERNET - PROTECT
ACCORDINGLY

Summary

¶1. (SBU) In the Ambassador's initial call, Energy Secretary Lotilla highlighted the need to increase competition and privatization in the electric power sector. Lotilla described promising developments in alternative energy sources throughout the country, including geothermal projects, the expansion of ethanol production, and greater utilization of bio-mass energy from sugarcane. He noted that diversification of energy sources away from fossil fuels has eased the burden of adjusting to higher oil prices in the power sector, though transportation relies heavily on imported oil. The Ambassador offered that the Embassy could serve as a useful channel to help engage the U.S. private sector in working towards the Energy Department's goals of market driven prices and privatization of assets. End Summary.

Power Sector Reform

¶2. (U) The Ambassador, accompanied by Econoffs and USAID officer, called on Secretary Raphael Lotilla on June 21 to review power sector developments and privatization efforts. Lotilla confidently described his agency's mandate "to bring power to the people" as a major part of President Arroyo's ten-point agenda. He noted that 2,500 villages throughout the Philippines are without electricity and that lack of electric power keeps these villages poor. Lotilla stated that, although Philippine electricity prices are among the highest in the region, the country spends less per capita on energy (\$570 annually per person) than neighboring countries (\$1,000 or more).

¶3. (SBU) Secretary Lotilla underscored the need for greater privatization, noting that the present system favors the "entrenched interests" of old public utility providers. He added that the goal of legislation such as the 2001 Electric Power Industry Reform Act was to introduce competition, noting that the Ramos Administration back in the 1990s held that the power sector was the last major hurdle in reforming the economy. Lotilla said that progress was indeed slow but

reforms continue. He said that competition was needed to determine correct pricing that would, in turn, ensure investment in new capacity. The government must undertake reforms while guarding against the old public monopoly becoming a private one. He said that on June 23 the first ever spot market for electricity would begin, though on a limited scale, for electricity in Manila, and help to encourage market-based prices. However, Lotilla cautioned that "the market is not a substitute for long-term supply contracts", which he cited as key to maintaining a stable supply and lower consumer prices. He also observed that Luzon Island overall has a slight overcapacity in supply that would work to the advantage of consumers.

14. (U) Lotilla noted the positive role of U.S. and other foreign investment in the power sector. Chevron, for example, was the largest investor in natural gas, though other companies like Shell receive wider media coverage here. He said that the Korean government's power plant investment channels its profits into foreign assistance for the Philippines. Lotilla contended that foreign investment in the sector was set to increase, with a number of firms interested in expansion.

Alternative Energy Sources

15. (U) Secretary Lotilla reported that the Philippines is second only to the U.S. in total production of geothermal energy. He said that Leyte Island, particularly endowed with geothermal resources, has the potential for exporting power to other parts of the Visayas region, which comprises the central islands of the Philippines. He added that there is interest in expanding the role of geothermal energy in Mindanao, which has seen rising demand for non-hydroelectric sources of power. However, there are logistical challenges in transmitting the electricity from one island to another as well as security vulnerabilities and natural disaster risks. He concluded that coal will continue to be an important energy source and said that preferably more clean-burning coal-fired plants would come online.

16. (U) Secretary Lotilla described the potential for utilizing bio-mass energy, particularly in sugarcane processing areas such as the Negros region in the west central part of the Philippines. The mills generate steam when producing sugar, 40% of which is unused; investors are interested in harnessing this energy.

17. (U) The Ambassador described her recent visit to the Ford plant in the Philippines that has begun production of flexible-fuel engines capable of using gasoline with up to 20% ethanol. Lotilla noted that farmers are indeed interested in entering into contracts with refineries to make ethanol more widely available in the domestic market. The Department of Energy is taking an "island by island approach" to ethanol, but Lotilla said that there is already a 50 centavo savings per liter (or about four U.S. cents per gallon) for consumers purchasing an ethanol-blend of gasoline. (Note: Current price of gasoline in Manila is about \$2.80 per gallon for regular).

18. (U) Lotilla acknowledged the assistance from USAID in expanding the use of alternative fuels for power and transport. He noted that the Energy Department has submitted a request to USAID for a study of the potential of jathropa, a plant-based bio-diesel fuel. He has also requested a study on the effects of excise tax reduction incentives to encourage use of alternate fuel vehicles.

Global Issues

19. (U) Secretary Lotilla said that most of the oil used by the Philippines is for transportation, not power generation, with 96% imported. He stated that the GRP is keenly

interested in the resolution of ongoing geopolitical events that affect the global energy picture. Lotilla noted the uncertainty over the Iran situation as a major factor in higher oil prices. Regarding GRP measures in response to the high oil prices, Lotilla clarified that the VAT tax will not be suspended from fuel, as has been reported, but rather the tariff duties on oil might be temporarily reduced from 3% to 1%. He explained that the easing of the tariff would not result in an overall reduction in government revenues since the tariff as well as the new 12 percent VAT are based on a percentage of the price, with higher oil prices generating increased revenues.

¶10. (U) Lotilla said that the GRP has no plans to develop strategic oil reserves because the costs are prohibitive. GRP maintains a 60-day reserve.

¶11. (U) The Ambassador invited Lotilla to encourage his staff to work closely with the Embassy, especially in dealing with bottlenecks in the privatization of power sector assets. In particular, the Ambassador expressed a willingness to serve as a catalyst in facilitating engagement with the U.S. private sector and building closer dialogue to promote reforms. The Ambassador underscored that global energy developments present a mutual challenge, and Lotilla expressed his appreciation for this offer of closer collaboration and for the overall discussion.

KENNEY